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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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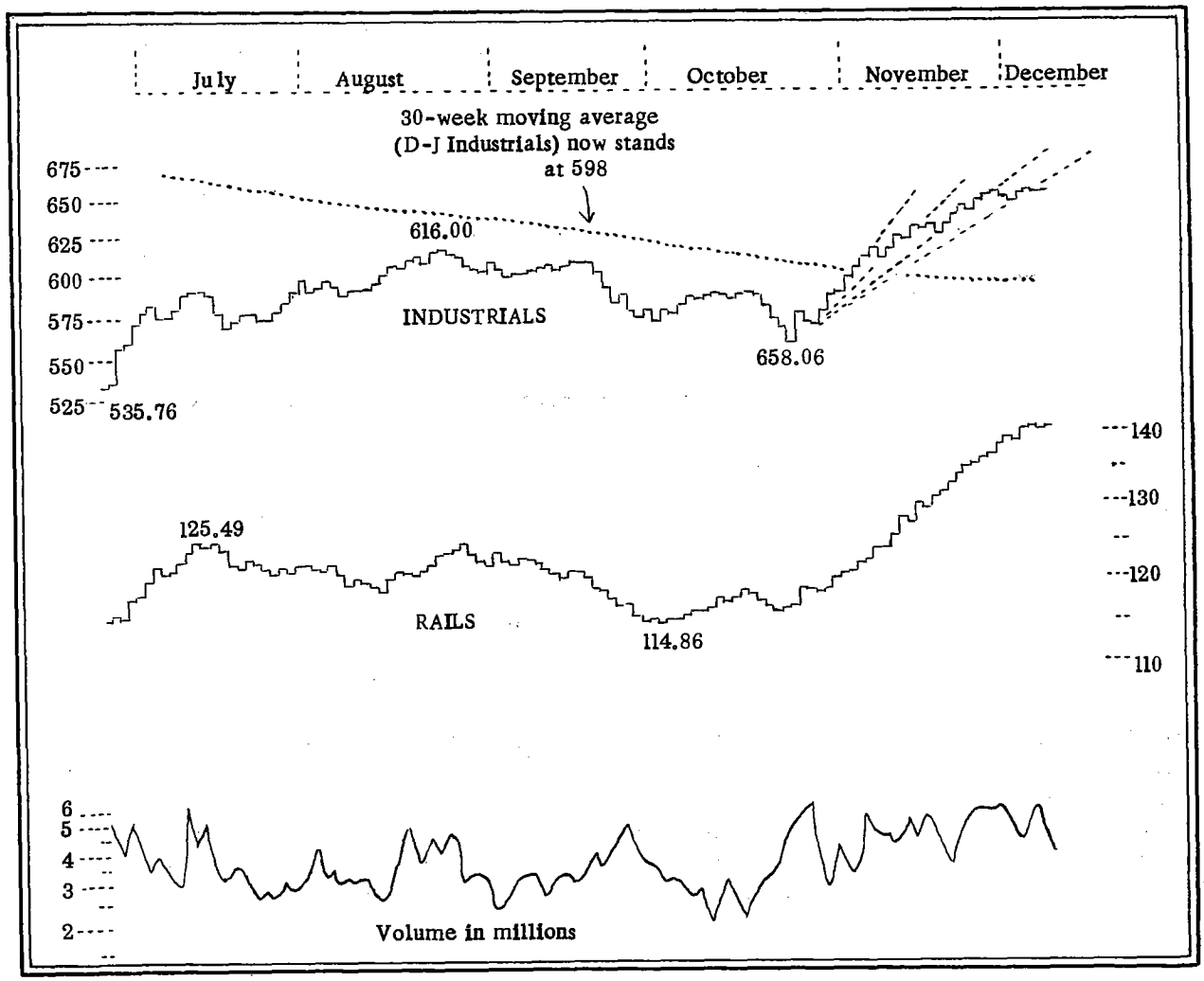
Phone calls and letters to this office have been increasing as bullish sentiment mounts. Over the past few weeks we have had a surge of inquiries. The questions run about as follows: "Isn't this a new bull market?" "Doesn't the strength in the Rails mean that the economy will boom next year?" "If we have a 10 billion dollar deficit and a 10 billion dollar tax cut, won't this be wildly inflationary? If so, shouldn't I be buying my head off?" "The 'cats and dogs' have not yet moved out. Aren't they great buys now?" "There seems to be all sorts of cash on the sidelines. Won't this money come into the market and drive it to new highs?"

On top of this, the financial pages are now crowded with bullish advertisements, each ad offering a different figure (i.e., 717-817, 750, 1182) as a potential peak for the Industrial Average. Such advertising is always calculated to attract the attention of bullish stockholders and potential buyers, and it serves to inflame speculative hopes.

"News goes with the trend." Many of the arguments which were used to "explain" the January-June collapse are now being dusted off and converted in order to rationalize the current rise. Budgets that were calculated to "wreck the country" are now seen as irresistable forces of inflation. "Large interest" money which was "driving the market down to embarrass our President" is now "coming in" with the purpose of forcing the shorts to the wall. Stocks that were still "too high" a few months ago are now seen to be "fully deflated" and ready for important accumulation.



Actually, I feel that much of the stock which has been purchased on this rise has been bought with the express purpose of "being traded out at higher prices." I have talked to few people who have said that they bought because they thought "such and such was a real 'value'." This type of buying is dangerous, because these buyers will run at the first sign of weakness. They bought to sell at higher prices. They will not hold if the market turns.

The current psychology suggests a rather interesting period of the past, a period when William Hamilton was writing his famous series of editorials for the Wall Street Journal. A bull market had ended in August, 1909. Three months later (in November) a corrective rally began, and many took the advance to be the start of a new bull market. Hamilton remained sceptical. On December 20, 1909 he wrote: "By all accounts we are to have a great bull market in the next six months when the public is to take stocks at the top. So far the judicious distribution of ground bait has not attracted fish in any great number." The market turned down in January of 1910 and continued down until July of that year.

From all sides I am told that there is no direction in the market but "up". The "bait" has been distributed, and it remains to be seen whether the "fish" will take stocks at prices substantially above the current levels.

* * * *

A number of subscribers have requested that I convert the page 1 chart of the Averages to semi-logarithmic scale. Beginning with the current issue, this chart will be drawn to exact semi-log proportions. As seen on the chart, the log scale gives a "new" (and completely correct) appearance to the pattern of the Averages. All movements now portray the rate or actual percentage of increase or decrease. As a result, the swings of the Industrials and Rails may be correctly compared and contrasted in terms of actual percentage of rally or decline.

A rise in the Industrial Average from 670 to 690 (20 points) may not yield profitable results to traders. But a rise from 160 to 180 (20 points) may provide substantial profits. The first represents a rise of 3%, the second a rise of 12 1/2%. On a semi-log chart an advance from 160 to 180 will show as a rise of better than four times (in actual distance) a rise from 670 to 690. In the final analysis, traders and investors are not dealing with points, they are dealing with percentages. The advantage of a semi-log scale is that it graphically portrays percentage of increase or decrease.

It is interesting to note the "variations" in pattern which may develop on semi-log scale as compared with arithmetic scale. I suggest that readers compare the page 1 chart with the simple arithmetic chart in the Wall Street Journal. Two things are immediately apparent. First, on the semi-log chart it is clear that the recent rise in the Rail Average has been considerably stronger than the rise in Industrials. In fact, for 24 consecutive trading days (October 29 to November 30) Rails held to a single trendline — a remarkable feat in itself.

It is equally interesting to observe the steady decrease in the rate of the Industrial advance. The four upward thrusts (each shallower than the last) can be measured by the four "fan-like" trendlines (dotted lines) which extend upward from the October (558.06) low. A series of such trendlines suggests a "rounding over" in the price structure and a gradual loss of upward momentum. The loss of momentum can be expected to produce either a "line" at the top or a correction as the rounding pattern turns down.

The arc-like rounding rise in Industrials since October 23 is actually quite extraordinary and is a pattern which has seldom been seen in the history of the Averages. Where such "scallop" structures have appeared in the past, they have usually been followed by a second arc which extends beyond the peak established by the first. The percentage rise in the second arc is usually not impressive, however, and the second peak has often marked the termination of the move.

As seen on the chart, the action of Industrials over the past two weeks has been almost sideways (Rails have moved sideways for the past week), and thus a small line has already been formed. In technically strong markets, lines can take the place of corrections. It is possible that we are seeing that phenomenon at this time.

COMPARISONS The 1962 crash came following three years of speculation, overvaluation, lofty price-earnings ratios and low yields (all typical of a bull market's third phase). The March-June collapse took both Averages through their preceding secondary lows and below the lows of 1960. In effect, this constituted a "double bear signal". In his book The Dow Theory Rhea wrote: "When declines in a primary bull market result in violating the lowest points encountered during the last major secondary reaction of that market, it may generally be assumed that the primary trend has changed from bullish to bearish." The 1962 decline took both Averages below two preceding sets of secondary lows on

great volume. The subsequent classic collapse in the majority of stocks gave credence to the bear market classification. To label the action of 1962 as anything but true bear market action strikes me as absurd.

Some observers view the current action as (1) a continuing correction of the 1962 crash. Others see the rise since June, 1962, as (2) a new bull market, or (3) a continuation of the bull market which began in 1949.

I cannot accept the current advance as being either number 2 or 3. If it is a new bull market, it came without benefit of a previously completed bear market. Neither duration, values, nor psychology at the June bottom suggested to me that 1962 saw the completion of the bear market. The violent rally of 1938 (see last Letter) came almost as "unexpectedly" as this one, but it arrived 13 months after the bull market top, and that bull market had been a relatively short one (five years). Moreover, Rhea had already identified a bear market third phase in early 1938. Writing in March, 1938 (one month before the final bottom) Rhea noted: "In the opinion of this writer, we are emerging from the second phase, and going into the third and final portion of the bear market. This may last for a week, a month, or many months." Stocks at that time had lost major portions of their value, the Industrial Average had dropped, and in March the average yield on the 30 Industrial stocks was 7.3%. The time was ripe on the basis of fundamentals and values for the birth of a new bull market. When the bull signal was given in June, 1938, Rhea had every reason to believe it was a valid one.

In contrast to the 1938 situation, the "bull market signal" of 1930 was obviously suspect. Nevertheless, it caught Rhea (and most other observers) by surprise. It was not logical that a new bull market would begin two months after the 1929 peak. History shows that bear markets tend to last 1/3 to 1/2 as long as their preceding bull markets. The 1921-29 bull market had been in effect for eight years. Two months (September to November, 1929) would seem to have been an impossibly short period for a full correction of an eight year bull market (even though the Industrial Average had suffered a 50% correction at the 1929 crash low).

When the 1930 rally took both Averages above their preceding (December, 1929) secondary highs Rhea noted that"... many observers took it to be a bull market signal. I can remember having shorted stocks early in December, 1929, after having completed a satisfactory short position in October. When the slow but steady advance of January and February carried above December, 1929, I became panicky and covered at considerable loss. With losses piling up every day, I forgot that the rally might normally be expected to retrace possibly 66% or more of the 1929 downswing. Nearly everyone was proclaiming a new bull market. Services were extremely bullish, and the upside volume was running higher than at the peak in 1929."

Referring to the current situation, the June, 1962, lows came only six months after the December, 1961, all-time high. The relatively short duration of the downswing (when compared to the long bull rise) does not suggest the termination of a bear market. Furthermore, if the 1962 bear market produced three recognizable phases, this writer failed to see them. Lastly, the very explosive and erratic nature of the rise suggests that it was corrective and not primary action.

As far as individual stocks are concerned (see recent Letters), many broke to new lows, then suddenly reversed and spiralled upward. Others have formed broadening formations (see Letter 202) and are now pushing against their upper trendlines (in a few cases the upper trendlines have been hurdled.) In a few instances, symmetrical triangles were broken on the downside, then reversed upward with no warning. Action of this sort is generally dangerous to follow It has, on past occasions, been a warning of things to come. From the standpoint of individual stocks, I would have expected a new primary bull market to have provided many impressive inverse head-and-shoulder accumulation patterns, large rectangles, ascending triangles and long lines of accumulation near the bottoms of major declines. Such patterns are lacking in the charts at this time.

LATE NOTES During the week ending November 30 the Industrial Average rose a total of 4.43 points on volume of 27 million shares (better than 5 million shares per day). Last week (week ending December 7) Industrials pushed up a total of 2.85 points on volume of 24 million shares. Thus 51 million shares changed hands in the last two weeks for a net gain of 7.28 Industrial points.

These statistics in themselves do not indicate definite weakness. But they do suggest that the market is meeting an increasingly large "supply" of stock as the rise progresses. Nevertheless, the fact that Industrials can make even minor progress in the face of a large volume of transactions implies that buying power is still stronger than selling pressure. Whatever weakness has appeared (so far) has appeared not in the general market statistics but in the action and patterns of many individual stocks.

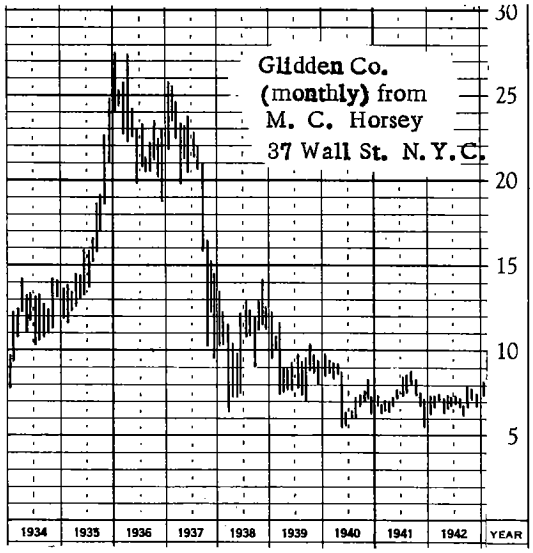
A steadily rising market will eventually attract important selling (and uninformed buying). The "churning" action described above (and in Letter 202) suggests that to some extent this is occurring now. If the market continues to push ahead without a correction, I would expect the advance to continue to show "churning" characteristics (i.e., a rise marked

 by heavy volume in relation to the amount of upside progress).

Few movements with as much momentum as this one have ended without some sort of "danger signal" in the actual price structure. Such signals generally take the form of (1) a non-confirmation between Industrials and Rails (one Average rises to a new high unconfirmed by the other), or (2) a period of divergent action (a few days or more) between those two indicators (one Average persistently advances while the other declines). Readers would do well to watch the price movement for either of these "tell-tale" signs.

STOCKS Of 346 representative stocks, 246 (71%) are now above their 30-week moving average. This is a sharp jump of 27% since the last Letter, and it moves the percentage above the 50% level. Strangely, of the same 346 stocks, only 176 (51%) are now above their August highs.

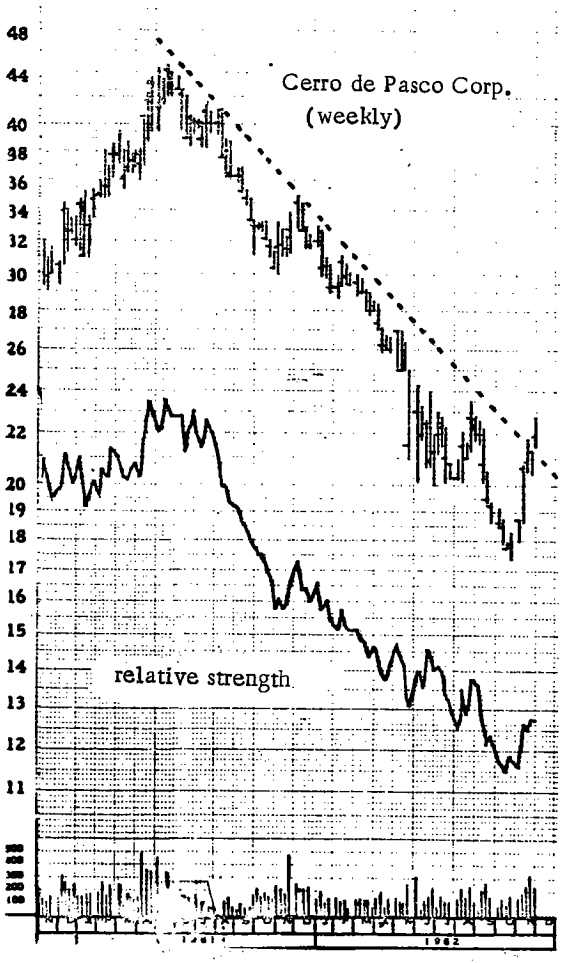
A great many issues have not yet risen substantially from their 1962 lows, and much is now being written about "a coming move in secondary issues and 'cats and dogs'." History may prove instructive along these lines. Glidden Company's 1937-38 action was fairly typical of the pattern of a majority of secondary issues during the '37 crash and thereafter. Note (chart at right) that Glidden dropped from a bull market high of 27 in 1936 to a crash-low of 6 1/2 in 1938. The stock then doubled (it rose to 14) during the "baby bull market" of 1938. This meant that those who bought Glidden around the 1938 lows did well in terms of percentages, but those who held Glidden through the 1937-42 period never had a chance to regain their terrific losses.



It is not uncommon for many issues to retrace approximately 50% of their losses in any sustained corrective action following a crash. With this in mind, it is worth noting that a good many stocks are now still in the vicinity (in terms of percentages) of their 1962 crash-lows. Traders who wish "insurance" on the upside might think in terms of speculative commitments in such issues (with the stipulation that these stocks be sold in case of a general market reversal).

Following is a fractional list of 1962 "collapses" which are essentially (in terms of percentages) on their lows. In many cases these stocks are now 50-80% below their bull market highs: Johns Manville, National Lead, Amer. Home Products, Allis Chalmers, Goodrich, U.S. Rubber, U.S. Steel, Schering, Air Reduction, Texas Instruments. (The following are of lesser quality): Curtis Wright, Brunswick, Burroughs, Amer. Photocopy, Smith Corona, Amphenol Borg, Sperry Rand, Raytheon, Amer. Machine & Foundry, Cerro de Pasco, Spiegel, Automatic Canteen, Standard Packaging.

For purposes of illustration, I include a chart of Cerro de Pasco. The stock dropped from a 1961 high of 44 1/2 to a 1962 low of 17 1/2 (a loss of 60% of its value). A 50% retracement of its 1962 collapse would take CDP to about 31. Although this would be small consolation for those who had "riden CDP down", it would represent a good profit from these levels.



DEFINITIONS A retired Army Colonel writes: "Undoubtedly you have read a variety of definitions of 'investors', 'speculators' and 'gamblers'. From your comments, it appears that you have some definitions of your own but have been reluctant to put them into prints."

In my opinion, an investor is a man who is concerned with "values" and the long-term trend of the market. A speculator is a man who will buy or sell or sell short (for the intermediate term) on the basis of his own carefully prepared studies. A gambler is a man who will buy XYZ Corp. because a friend told him that "it is going up." The gambler knows nothing of XYZ Corp, the trend of the market or the point at which he should cut his losses.

Chart of Cerro courtesy of Traders Research, P.O. Box 2466, St. Louis 16, Missouri.